Suspension of Interest and Failure-to-Pay Penalties Were Not Always Calculated Correctly for Tax Credits

August 2003

Reference Number: 2003-10-155

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 29, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: for Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - Suspension of Interest and Failure-to-Pay Penalties Were Not Always Calculated Correctly for Tax Credits (Audit # 200210043)

This report presents the results of our review of the Internal Revenue Service's (IRS) compliance with provisions for the suspension of interest and calculation of penalties on disallowances of refundable tax credits. Our overall objective was to determine if the calculations of suspension of interest for the 30-Day Rule[1] and for Failure-to-Pay (FTP) penalties[2] were correct when there was an adjustment to refundable tax credits such as the Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Gas Tax Credit (GTC), and Withholding Tax Credit (WTC).

In summary, we found that interest under the 30-Day Rule and FTP penalties were not always calculated correctly on the disallowances of tax credits. Taxpayers had not been given the benefit of suspension of interest under the 30-Day Rule on disallowances of the EITC prior to 2003. As a result of our reviews of suspension of interest provisions, Master File[3] programming has now been corrected to allow this benefit on EITC disallowances; however, additional corrections are needed to allow the benefit of suspension of interest on disallowances of the CTC and GTC. We found that suspension of interest was inappropriately being allowed for disallowances of the WTC,

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[1] Internal Revenue Code (I.R.C.) § 6601(c) (2002).
[2] I.R.C. § 6651(a) (2002).
[3] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

which does not qualify for the benefit of the 30-Day Rule. Also, FTP penalties were not always calculated correctly for the disallowance of the EITC and WTC. The incorrect calculations resulted in some taxpayers being overcharged FTP penalties and some taxpayers being undercharged FTP penalties.

We recommended that the IRS complete programming corrections for the 30-Day Rule and FTP penalties for disallowances of the EITC, WTC, CTC, and GTC. We also recommended that accounts be corrected for approximately 114,500 taxpayers who are due credits or refunds of the FTP penalty.

Management's Response: IRS management agreed with our recommendations and is taking appropriate corrective actions. The corrective actions include the submission of requests for computer programming corrections and analysis of how best to refund taxpayer overpayments. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Background

Generally, taxpayers are charged interest on additional Internal Revenue Service (IRS) tax assessments from the due date of the tax return to the date that the additional tax is paid. Internal Revenue Code (I.R.C.) Section (§) 6601(c)[1] was enacted to provide relief to taxpayers in the form of suspending interest when the IRS takes longer than 30 days to bill a taxpayer for an agreed tax deficiency. This provision is often referred to as the "30-Day Rule" for interest computations. In addition to these interest charges, I.R.C. § 6651(a)[2] provides for a Failure-to-Pay (FTP) penalty on tax deficiencies that are not timely paid. The computations of interest for the 30-Day Rule and for the FTP penalty are determined, in part, by whether or not a liability meets the specific definition of a tax deficiency.

In July 1980 and September 1981, the IRS Office of Chief Counsel issued opinions holding that Earned Income Tax Credit (EITC) disallowances would not be treated as tax deficiencies. The Congress had previously amended the I.R.C.[3] in June 1965 to treat the Gas Tax Credit (GTC) disallowances as tax deficiencies. In November 1988, the Congress amended the I.R.C.[4] to specify that the EITC should also be treated as tax deficiencies. This amendment was enacted to afford taxpayers access to the United States Tax Court, but it also affected interest and penalty provisions. In December 2000, the Congress defined Child Tax Credit (CTC) disallowances as a tax deficiency.[5] As a result of these amendments, taxpayers should be allowed the benefit of the 30-Day Rule, and they should be subjected to the assertion of the FTP penalty when the EITC, GTC, or CTC is disallowed.

During a prior Treasury Inspector General for Tax Administration audit in Fiscal Year 2002,[6] we found

[1] I.R.C. § 6601(c) (2002).
[2] I.R.C. § 6651(a) (2002).
[3] Excise Tax Reduction Act of 1965, Pub. L. No. 89-44, § 136 (1965).
[4] Technical and Miscellaneous Revenue Act of 1998, Pub. L. No. 100-647, § 1019 (1988).
[5] Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, Appendix G, § 314(a), 114 Stat. 2763A-587 (2000).
[6] *The New Suspension of Interest Provision Is Not Always Calculated Correctly* (Reference Number 2002-10-187, dated September 2002).

indications that computer programming may not have been updated to treat EITC disallowances as tax deficiencies when calculating interest and FTP penalties. The IRS uses two computer systems to manage taxpayer accounts. The Master File is the IRS database that stores various types of taxpayer account information, while the Integrated Data Retrieval System (IDRS) is the IRS computer system used to retrieve information, provide billings, and update stored information on the Master File. Both computer systems calculate interest and penalties separately from each other.

We initiated this audit to determine if the IRS was accurately calculating interest (under the 30-Day Rule) and the FTP penalties on disallowances of the EITC, CTC, and GTC. We obtained documents from and held discussions with employees in the Small Business/Self-Employed (SB/SE) Division and the Information Technology Services (ITS) organization at the New Carrollton, Maryland, office. This audit was conducted from November 2002 to May 2003 in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Taxpayers Were Not Given the Appropriate Benefit of the 30-Day Rule When the Earned Income Tax Credit Was Disallowed

The 30-Day Rule allows an interest-free period for taxpayers who agree to an EITC disallowance. The interest-free period should start on the 31st day following the agreement date and continue until the taxpayer is billed for any unpaid EITC disallowance. When the Congress amended the I.R.C. to treat EITC disallowances as tax deficiencies in November 1988, computer programming was not updated to give taxpayers the benefit of the 30-Day Rule. Although we do not know the total number of taxpayers affected since 1988, based on our computer analysis and sample cases, we estimate 188,500 taxpayers were over assessed approximately $2 million in interest charges during October 1998 through April 2002.

We advised SB/SE Division and ITS function officials in September 2002 that the EITC disallowance was not being treated correctly for a related suspension of interest provision.[7] SB/SE Division officials immediately coordinated with ITS function programmers to initiate a correction for the 30-Day Rule, effective January 2003 for the Master File interest computations. Had this error not been corrected in January 2003, we estimate that 265,000 taxpayers could have been over assessed approximately $2.8 million in interest charges over a projected 5-year period.

Although the Master File programming had been corrected in January 2003, taxpayers continued to receive bills with overstated interest calculations. In February 2003, we determined that the IDRS program that produces taxpayer billings had not yet been updated. ITS function officials advised us that they had not yet received instructions from SB/SE Division officials to correct the billing program. The billing program is part of the IDRS and uses a computer program to calculate interest under the 30-Day Rule; the IDRS computer program is separate from the Master File computer program.

From January to March 2003, taxpayers received bills from the IDRS process that reflected more interest than the taxpayers had been assessed or owed on their Master File accounts. We notified SB/SE Division and ITS function officials, who immediately implemented some corrective actions to the IDRS programming for the EITC disallowances, effective as of March 2003. However, the IDRS still did not allow the benefit of the 30-Day Rule to all taxpayers agreeing to the EITC disallowances. Had IDRS programming not been corrected, we estimate that approximately 265,000 taxpayers would have been issued incorrect billings over a projected 5-year period. We estimate taxpayer bills were overstated on average by approximately $10.

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[7] *The New Suspension of Interest Provision Is Not Always Calculated Correctly* (Reference Number 2002-10-187, dated September 2002).

Recommendation

1. The Commissioner, SB/SE Division, should request that the Chief Information Officer (CIO) correct the IDRS computation to allow the benefit of the 30-Day Rule on all EITC disallowances, when applicable.

Management's Response: The SB/SE Division will submit a request that disallowance of the EITC be included in the 30-Day Rule for IDRS processing.

Taxpayers Have Been Incorrectly Charged Failure-to-Pay Penalties When the Earned Income Tax Credit Was Disallowed

The I.R.C. imposes penalties when taxpayers fail to timely pay income tax. An FTP penalty[8] is generally required when a taxpayer fails to timely pay the amount of income tax that is reflected on the tax return as filed. A separate FTP penalty[9] is imposed when a taxpayer fails to timely pay the assessment of an additional tax deficiency after the filing of a return. Although both of these FTP penalties have the same basic rates, they have different rules as to what amounts to use and when the penalties will start to accrue. The FTP penalty due on a return as originally filed is based on the tax due amount and starts to accrue on the due date of the return. The FTP penalty due on an additional tax deficiency determined after the original filing of a return starts to accrue after the assessment of the additional tax deficiency, which is later than the due date of the return. When the EITC is disallowed in an examination, the assessment, if not timely paid, is subject to the FTP penalty due on an additional tax deficiency after the filing of return.

In August 2000, the IRS took action to correct programming for inaccurately assessed and billed FTP penalties when the EITC was disallowed. Computer programming for the FTP penalty had not been updated in November 1988 when the Congress amended the I.R.C. to treat EITC disallowances as tax deficiencies. The IRS finished correcting the Master File programming in January 2003.

Prior to January 2003, the Master File and IDRS were inappropriately assessing the FTP penalty based on the original tax due and due date of the return rather than on the

[8] I.R.C. § 6651(a)(2) (2002).
[9] I.R.C. § 6651(a)(3) (2002).

tax deficiency assessment amount and date. This resulted in many taxpayers being over assessed the FTP penalty for periods before the assessment date. The computer programs were also not asserting the required FTP penalty based on the assessment date of the tax deficiency when taxpayers did not timely pay, causing taxpayers to be under assessed the FTP penalty.

Although some taxpayers were not affected by the incorrect FTP penalty computations, other taxpayers were over assessed or under assessed FTP penalties. In 172 (48 percent) of 360 accounts sampled that had EITC adjustments during October 1998 through December 2001, taxpayers were not affected because they had timely paid the EITC disallowance and did not owe an FTP penalty. In 110 (31 percent) accounts, taxpayers that had not paid the EITC disallowance timely were under assessed the FTP penalty. Based on our sample, we estimated that 578,750 taxpayers had been under assessed FTP penalties of at least $7.50 in the first month. In 8 (2 percent) accounts, taxpayers were over assessed FTP penalties. We estimated that 42,000 taxpayers were due an average credit or refund of about $80, totaling $3.4 million. In 70 (19 percent) accounts, taxpayers had been both over assessed and under assessed FTP penalties. We estimated 368,000 taxpayers have offsetting FTP penalty computation errors that would result in additional billings or refunds to these taxpayers.

In June 2002, the SB/SE and Wage and Investment Divisions were considering a proposal for correction and refund of erroneous FTP penalties on EITC disallowances. They estimated that as many as 3.5 million taxpayers might be due a credit or refund of about $62 each, totaling $217 million. This estimate incorrectly considered only over assessed FTP penalties calculations and did not consider the under assessed FTP penalties that may have caused offsets and additional billings. A decision paper was drafted in June 2002 proposing that no corrections be made because “To attempt to correct all closed cases would seemingly be an impossible task.” However, the decision was never approved, and no action was ever initiated on the refund program.

We believe the IRS should not correct the estimated 368,000 taxpayers accounts with offsetting calculation errors that may result in taxpayers receiving additional billings for insignificant amounts. However, we do believe that the IRS should systemically correct the accounts for the estimated 42,000 taxpayers who are due a credit or refund of about $80 each.

By January 2003, the Master File programming changes were implemented to correct the FTP penalty program computations. The IDRS programming was also updated to correct computations of FTP penalties based on the due date of the return. However, as of the end of our account reviews in May 2003, IDRS programs for EITC disallowances had not yet been updated to compute the FTP penalties based on the tax deficiency assessment dates.

Since January 2003, taxpayers with EITC disallowances have had conflicting FTP penalty information reflected on the IDRS and Master File systems. Taxpayers have received bills that do not reflect the total FTP penalties that had been assessed or owed on their Master File accounts. Taxpayers may not become aware of the total FTP penalty amounts owed until a refund is unexpectedly withheld to pay the additional penalties. We believe that taxpayers may also have been given incorrect information if they contacted the IRS concerning their account balance or if they attempted to establish a payment agreement. We estimate that over a projected 5-year period approximately 890,000 taxpayers would receive IDRS billings understating the amount of FTP penalties on EITC disallowances.

When the ITS function corrects the IDRS programming, some taxpayers may receive bills that reflect additional FTP penalties that had not been previously billed. We estimate that the taxpayers' bills were understated, on average, by approximately $7.50 per month per taxpayer in FTP penalties. This may result in taxpayer inquiries to the IRS Customer Service, Enforcement, and Taxpayer Advocate offices.

Recommendations

2. The Commissioner, SB/SE Division, should correct the estimated 42,000 taxpayer accounts that are due credits or refunds of over assessed FTP penalties when the EITC was disallowed.

Management's Response: The SB/SE Division will conduct an analysis to determine whether a systemic or manual process would be best to address these taxpayer account adjustments. Once the analysis is complete, appropriate actions will be taken on the taxpayer accounts.

3. The CIO should expedite the IDRS programming update to compute the FTP penalties for EITC disallowances based on the tax deficiency assessment dates, coordinate with the Master File programming, and alleviate any additional potential taxpayer burden that incorrect billings may cause.

Management's Response: The CIO organization is currently reprogramming the IDRS FTP penalty as requested by the SB/SE Division.

4. When the IDRS programming is updated to correct FTP penalty calculations, the Commissioner, SB/SE Division, should notify appropriate IRS offices (e.g., Accounts Management, Wage and Investment Division) of the effect of inconsistent IDRS billings on taxpayers' accounts.

Management's Response: The SB/SE Division will notify the appropriate IRS offices of the effect of inconsistent IDRS billings on taxpayers' accounts, after the IDRS programming is updated to correct FTP penalty calculations.

Taxpayers Were Inappropriately Given the Benefit of the 30-Day Rule When the Withholding Tax Credit Was Disallowed

Decreases in the amounts of allowable Withholding Tax Credit (WTC) are not considered to be tax deficiencies by the I.R.C.[10] Therefore, disallowances of the WTC do not qualify for the 30-Day Rule. In January 2003, when the IRS adjusted programming to appropriately apply the 30-Day Rule for EITC disallowances, programming affecting the WTC was also changed. The additional programming

[10] I.R.C. § 6601(c) (2002).

incorrectly allowed the 30-Day Rule to be applied to WTC disallowances in taxpayer accounts when additional adjustments occurred on the same account.

Therefore, beginning in January 2003, for Master File assessments, taxpayers who have agreed to disallowances of the WTC are being under assessed interest due to the incorrect application of the 30-Day Rule. Since this condition had been ongoing for only a few months at the time of our audit, we were not able to determine the number of taxpayers affected. SB/SE Division and ITS function officials expressed concerns that a change to this calculation may adversely affect taxpayers because of unexpected, negative impacts on other interest program calculations due to the current programming complexity and interdependencies. If it was not feasible to correct the programming, they would wait until the program change could be made on the future IRS computer modernization process.

Recommendation

5. The Commissioner, SB/SE Division, should coordinate with the CIO to determine the feasibility of correcting the Master File and IDRS computations of the 30-Day Rule for WTC disallowances for the current programming or during the future IRS computer modernization process.

Management's Response: The SB/SE Division will coordinate with other IRS offices to include in the computer modernization work plans processing that will apply the 30-Day Rule to WTC disallowances when underpayment interest programming is developed.

Taxpayers Were Incorrectly Charged Failure-to-Pay Penalties When Withholding Tax Credits Were Disallowed

The I.R.C.[11] imposes a penalty when a taxpayer fails to timely pay an amount of tax reflected on the tax return. This FTP penalty is separate from, and can be in addition to, the FTP penalty assessed on additional tax deficiencies. When a prepayment credit, such as the WTC, is reduced after the filing of a return, the taxpayer might not have

[11] I.R.C. § 6651(a)(2) (2002).

sufficient credits to fully pay the taxes reflected on the tax return. If the credits are not sufficient to fully pay the taxes, an FTP penalty should be assessed based on the tax amount due.

We found that the FTP penalty is being inappropriately assessed on taxpayers' accounts with WTC disallowances, even though there are sufficient credits still available to fully pay the taxes as shown on the returns. Based on review of a random sample of 300 taxpayer accounts having disallowances of the WTC, we estimate that 72,500 taxpayers were over assessed approximately $10.5 million in FTP penalties during October 1998 through August 2002. We estimated that, on average, taxpayers were over assessed $145 in penalties.

In August 2000, the SB/SE Division had requested that the ITS function correct the FTP calculation of EITC and WTC disallowances. Programming of the FTP calculation for WTC disallowances had not been changed since Calendar Year 1990. Although the corrections were made to the FTP calculation of the EITC by January 2003, the WTC corrections were postponed. Due to a miscommunication between the SB/SE Division and the ITS function as to needed follow-up actions for the WTC corrections, the programming changes had been postponed indefinitely and were raised again by our audit.

Recommendations

6. The Commissioner, SB/SE Division, should submit a request that the CIO complete the Master File and IDRS computer programming for calculating the FTP penalty for taxpayers having WTC disallowances.

Management's Response: The SB/SE Division will coordinate with the CIO organization to complete the required program changes for the FTP penalty for taxpayers with a WTC disallowance using the existing August 2000 request or, if needed, through a new request.

7. The Commissioner, SB/SE Division, should correct the accounts for the estimated 72,500 taxpayers who were

over assessed FTP penalties when the WTC was disallowed.

Management's Response: The SB/SE Division will conduct an analysis to determine whether a systemic or manual process would be best to address these taxpayer account adjustments. Once the analysis is complete, appropriate actions will be taken on the taxpayer accounts.

Taxpayers Have Been Incorrectly Charged Failure-to-Pay Penalties and Not Given the Benefit of the 30-Day Rule When Child Tax Credits and Gas Tax Credits Were Disallowed

The CTC and GTC disallowances are identified by the I.R.C.[12] as tax deficiencies in the same way as the EITC. Therefore, taxpayers should receive the benefit of the 30-Day Rule and should be subject to the FTP penalty for tax deficiencies if the liabilities are not paid timely.

We could find no record of computer programming requests to properly calculate interest and penalties on CTC and GTC disallowances. The Congress amended the I.R.C. in June 1965 to treat the GTC disallowances as tax deficiencies, and in December 2000 the Congress added the CTC to the tax deficiency definitions. The IRS has initiated action to ensure that the 30-Day Rule and FTP penalties were correctly calculated for EITC disallowances. However, due to an oversight, the IRS has not yet taken action to address the CTC and GTC disallowances.

Taxpayers are being over assessed interest and may have been over assessed FTP penalties. Based on review of a random sample of 300 accounts, we estimate that approximately 6,500 taxpayer accounts with CTC disallowances during October 1998 through August 2002 were over assessed interest since they did not receive the benefit of the 30-Day Rule. We estimate that, during this same period, 39,000 accounts had incorrect calculations of the FTP penalty on CTC disallowances. We estimate that if not corrected over a 5-year period approximately 8,300 taxpayers could have incorrect interest calculations and 50,000 taxpayers could have incorrect FTP penalty calculations on CTC disallowances. We did not find in our random sample a taxpayer account having a GTC disallowance for which the 30-Day Rule and FTP penalty

[12] I.R.C. § 6601(c) (2002).

applied. However, ITS function programmers confirmed that the interest and FTP penalty calculations for the disallowance of the GTC were currently the same as those for the CTC and, therefore, also needed to be corrected.

Recommendation

8. The Commissioner, SB/SE Division, should submit a request to the CIO to correct the Master File and IDRS computer programming for calculating interest under the 30-Day Rule and the FTP penalty for taxpayers having CTC or GTC disallowances.

Management's Response: The SB/SE Division will submit a request to include the disallowance of the CTC in the 30-Day Rule computations and provide for the correct computation of the FTP penalty when the CTC is disallowed. Because there is no current systemic means to identify a GTC disallowance and the volume is low, the SB/SE Division will update IRS procedures to require the manual computation and restriction of interest when GTC disallowances are processed.

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objective was to determine if the calculations of suspension of interest for the 30-Day Rule[1] and for Failure-to-Pay (FTP) penalties were correct when there was an adjustment to refundable tax credits such as the Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Gas Tax Credit (GTC), and Withholding Tax Credit (WTC). To accomplish our objective, we performed the following tests:

I. To determine what governs the treatment of the EITC, CTC, GTC, and WTC for the 30-Day Rule and for FTP penalties, we researched the Internal Revenue Code and Internal Revenue Service (IRS) Office of Chief Counsel opinions.

II. To determine if the IRS was properly applying the 30-Day Rule when the EITC was disallowed, we reviewed a sample of 340 taxpayer accounts from a Master File[2] extract. To project our results for both attributes and dollar amounts, we used a statistically valid random sampling methodology with a 95 percent confidence level, a 33 percent expected error rate, and a precision of +/- 5 percent. Our population of 451,270 accounts represented all accounts having disallowances of the EITC that posted during October 1998 through April 2002. During discussions with Small Business/ Self-Employed (SB/SE) Division and Information Technology Services (ITS) function employees, we considered the causes for incorrect calculations and how taxpayers were affected by the 30-Day Rule computations for both the Master File and Integrated Data Retrieval System (IDRS)[3] programs.

III. To determine if the IRS was properly applying FTP penalties when the EITC was disallowed, we reviewed a sample of 360 tax accounts with EITC disallowances from the IRS' 1 percent Master File database. To project our results, we used a statistically valid random sampling methodology with a 95 percent confidence level, a 62 percent expected error rate, and a precision of +/- 5 percent. Our population of 18,941 accounts represented 1 percent of the total Master File accounts with disallowances of the EITC that posted during October 1998 through December 2001. During discussions with SB/SE Division, ITS function, and Wage and Investment Division employees, we reviewed the IRS' proposed plan to credit or refund over assessed FTP penalties and considered how taxpayers were affected by both the Master File and IDRS programs.

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[1] I.R.C. § 6601(c) (2002) is commonly referred to as the 30-Day Rule.
[2] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[3] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

IV. To determine if the IRS was properly applying the 30-Day Rule when the WTC was disallowed, we reviewed a judgmental sample of 50 accounts from a Master File extract. Since we did not expect any error to have occurred over a significant period of time to date, we used a judgmental sampling methodology and selected 50 accounts having WTC disallowances within a grouping based on Social Security Numbers. Our population of 451,270 represented all Master File accounts having a disallowance of the EITC, and potentially the WTC, between October 1998 and April 2002.

V. To determine if the IRS was properly applying FTP penalties when the WTC was disallowed, we reviewed a stratified sample of 300 taxpayer accounts from the IRS' 1 percent Master File database. To project our dollar results, we used a statistically valid, random, stratified sampling methodology based on a 95 percent confidence level and a precision of +/- 5 percent. Our population of 5,077 accounts represented 1 percent of the total Master File accounts with disallowances of the WTC that posted during October 1998 through August 2002. During discussions with SB/SE Division and ITS function employees, we considered the causes for incorrect calculations and how taxpayers were affected by the FTP penalty computations for both the Master File and IDRS programs.

VI. To determine if the IRS was properly applying the 30-Day Rule and FTP penalties when the CTC and GTC were disallowed, we reviewed a sample of 300 tax accounts from the IRS' 1 percent Master File database. To project our results, we selected a statistically valid, random sample using a 95 percent confidence level, a 25 percent expected error rate, and a precision of +/- 5 percent. Our population of 6,554 accounts represented 1 percent of the Master File accounts having adjustments to miscellaneous prepayment credits during October 1998 through August 2002. During discussions with SB/SE Division and ITS function employees, we considered the causes for incorrect calculations and how taxpayers were affected by the interest and penalty computations for both the Master File and IDRS programs.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 265,000 taxpayers over a 5-year period could have been over assessed approximately $2.8 million in interest expenses if the Master File[1] programming had not been corrected to allow the suspension of interest under the 30-Day Rule for Earned Income Tax Credit (EITC) disallowances (see page 2).

Methodology Used to Measure the Reported Benefit:

Using an extract from the Internal Revenue Service's (IRS) Master File computer system, we identified a population of 451,270 individual tax accounts that had EITC disallowances during October 1998 through April 2002. We reviewed a statistically valid random sample of 340 of these accounts to determine the correct calculation of interest using the 30-Day Rule. Using a 95 percent confidence level and the error rate of 41.76 percent (142 out of 340), we estimate that 188,500 taxpayers (+/- 5.2 percent) had incorrect interest calculations. Using variables sampling projections, we estimate that these taxpayers were over assessed approximately $2 million (+/- $1 million). The correction already completed by the IRS was a direct result of our discussion of recommendations during a prior audit.[2] Over a 5-year period, this projects to 265,000 taxpayers and $2.8 million ($2 million/185 weeks in sample period times 260 weeks in a 5-year period).

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 42,000 taxpayers are due a credit or refund of $3.4 million because FTP penalties were incorrectly calculated on EITC disallowances (see page 4).

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[1] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] *The New Suspension of Interest Provision Is Not Always Calculated Correctly* (Reference Number 2002-10-187, dated September 2002).

Methodology Used to Measure the Reported Benefit:

Using the IRS' 1 percent Master File database, we identified a population of 18,941 accounts having a disallowance of the EITC during October 1998 through December 2001. As a statistically valid 1 percent file, these accounts represented a population of 1,894,100 accounts. We reviewed a statistically valid sample of 360 accounts and found 8 accounts were due a credit or refund due to over assessment of the FTP penalty on EITC disallowances. Using a 95 percent confidence level and the error rate of 2.2 percent, we project that 42,000 accounts (+/- 1.5 percent) are due a credit or refund. Using variables projection techniques, we estimate these taxpayers are due refunds of approximately $3.4 million (+/- $2.8 million).

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 890,000 taxpayers over a 5-year period may receive incorrect billings because the IRS billing system is not correctly calculating the FTP penalty on EITC disallowances (see page 4).

Methodology Used to Measure the Reported Benefit:

Using the IRS' 1 percent Master File database, we identified a population of 18,941 accounts with an EITC disallowance during October 1998 through December 2001. As a statistically valid 1 percent file, these accounts represented a population of 1,894,100 accounts. We reviewed a statistically valid sample of 360 accounts and found the FTP penalty was understated on 110 accounts that would have received at least 1 Integrated Data Retrieval System (IDRS)[3] billing. Since the IDRS is still understating the FTP penalty while the Master File is asserting the penalty on EITC disallowances, we estimated the number of taxpayers who could receive incorrect billings from the IDRS over a 5-year period. Using a 95 percent confidence level and the error rate of 30.56 percent, we projected that approximately 578,750 accounts (+/- 4.76 percent) could have received incorrect billings during October 1998 through December 2001. Over a 5-year period, this projects to 890,000 taxpayers (578,750 accounts/169 weeks in sample period times 260 weeks in a 5-year period).

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 72,500 taxpayers were over assessed $10.5 million in FTP penalties because the FTP penalty was incorrectly calculated on Withholding Tax Credit (WTC) disallowances (see page 8).

Methodology Used to Measure the Reported Benefit:

Using the IRS' 1 percent Master File database, we identified a population of 5,077 accounts that had a WTC disallowance during October 1998 through August 2002. As a statistically valid 1 percent file, these accounts represented a population of 507,700 accounts. We reviewed a

[3] The IDRS is the IRS computer system used to retrieve information, provide billings, and update stored information on the Master File.

statistically valid stratified sample of 300 accounts and found the FTP penalty was overstated on 29 accounts. Using a 95 percent confidence level and a stratified error rate of 14.29 percent, we projected that approximately 72,500 accounts (+/- 5.9 percent) were over assessed FTP penalties. Using variables sampling projections, we estimate that these taxpayers were over assessed approximately $10.5 million (+/- $5.5 million).

<u>Type and Value of Outcome Measure:</u>

- Taxpayer Rights and Entitlements – Potential; 8,300 taxpayers over a 5-year period could have been over assessed interest due to the incorrect application of the 30-Day rule on Child Tax Credit (CTC) disallowances (see page 10).

<u>Methodology Used to Measure the Reported Benefit:</u>

Using the IRS' 1 percent Master File database, we identified a population of 6,554 accounts that had a miscellaneous prepayment credit disallowance during October 1998 through August 2002. As a statistically valid 1 percent file, these accounts represented a population of 655,400 accounts. We reviewed a statistically valid sample of 300 accounts and found that interest was overstated on 3 accounts having a CTC disallowance. Using a 95 percent confidence level and the error rate of 1 percent, we estimated 6,500 accounts (+/- 1.1 percent) contained over assessed interest on CTC disallowances. Over a 5-year period, this projects to 8,300 taxpayers (6,500 accounts/203 weeks in sample period times 260 weeks in a 5-year period).

<u>Type and Value of Outcome Measure:</u>

- Taxpayer Rights and Entitlements – Potential; 50,000 taxpayers over a 5-year period could have incorrect calculations of the FTP penalty on CTC disallowances (see page 10).

<u>Methodology Used to Measure the Reported Benefit:</u>

Using the IRS' 1 percent Master File database, we identified a population of 6,554 accounts that had a miscellaneous prepayment credit disallowance during October 1998 through August 2002. As a statistically valid 1 percent file, these accounts represented a population of 655,400 accounts. We reviewed a statistically valid sample of 300 accounts and found the FTP penalty was incorrectly calculated on 18 accounts with a CTC disallowance. Using a 95 percent confidence level and the error rate of 6 percent, we estimated approximately 39,000 accounts (+/- 2.7 percent) contained overstated interest on CTC disallowances. Over a 5-year period, this projects to approximately 50,000 taxpayers (39,000 accounts/203 weeks in sample period times 260 weeks in a 5-year period).

Appendix V

Management's Response to the Draft Report

SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG 14 2003

RECEIVED
AUG 14 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Dale F. Hart
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Suspension of Interest and Failure-to-Pay Penalties Were Not Always Calculated Correctly for Tax Credits (Audit # 200210043)

I have reviewed your report and I agree with your recommendations. The Internal Revenue Code (IRC) Section 6601(c) was enacted to provide relief to taxpayers by suspending interest when the IRS takes longer than 30 days to process an agreed additional tax or penalty assessment. This provision is known as the 30-Day Rule.

Due to programming problems, we did not always suspend interest when we adjusted refundable tax credits and assessed the failure to pay penalty. Once we were made aware of the programming problems, we immediately corrected both the Master File and Integrated Data Retrieval System (IDRS) programs. The Office of Penalties and Interest has worked extensively with Business Systems Development (BSD) within Information Technology Services (ITS), to apply the 30-Day Rule in the Master File and IDRS processing for the Failure-to-Pay (FTP) penalty, Earned Income Tax Credit (EITC) and Withholding Tax Credit (WTC).

Our responses to your recommendations are as follows:

RECOMMENDATION 1
The Commissioner, Small Business/Self-Employed (SB/SE) Division, should request that the Chief Information Officer correct the IDRS computation to allow the 30-Day Rule on all EITC disallowances, when applicable.

CORRECTIVE ACTION
The Program Manager, Office of Penalties and Interest, will submit a Request for Information Services (RIS) to BSD requesting that disallowances of EITC be included in the 30-Day Rule for IDRS processing.

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IMPLEMENTATION DATE
Submission of RIS - September 15, 2003
Implementation of the programming changes - January 15, 2006

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 2
The Commissioner, SB/SE Division, should correct the estimated 42,000 taxpayer accounts that are due credits or refunds of over assessed FTP penalties when the EITC was disallowed.

CORRECTIVE ACTION
In conjunction with BSD, the Office of Penalties and Interest will look into the feasibility of using a systemic change to correct these accounts. This will be done with a focus on open years in order to mitigate unforeseen consequences to other taxpayers. There is a concern that any systemic change could affect many other taxpayers who were favorably impacted by the programming problem identified in this report. If a systemic change is not practical, a manual process will be used. The manual process will include stratification of the accounts and a cost analysis. Once our analysis is complete, we will take actions on the accounts as appropriate.

IMPLEMENTATION DATE
Completion of analysis – February 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 3
The Chief Information Officer should expedite the IDRS programming update to compute the FTP penalties for EITC disallowances based on the tax deficiency assessment dates to coordinate with the Master File programming, and to alleviate any additional taxpayer potential burden that incorrect billings may cause.

CORRECTIVE ACTION
Business Systems Development is currently reprogramming the IDRS FTP penalty as requested in the customer RIS.

IMPLEMENTATION DATE
Implementation of programming changes - January 15, 2004

RESPONSIBLE OFFICIAL(S)
Chief Information Officer
Director, Business Systems Development

CORRECTIVE ACTION MONITORING PLAN
Business Systems Development will work with Treasury Inspector General for Tax Administration (TIGTA) to run a recalculation once the reprogramming has been completed.

RECOMMENDATION 4
When the IDRS programming is updated to correct FTP penalty calculations, the Commissioner, SB/SE Division should notify appropriate IRS offices (e.g., Accounts Management, Wage & Investment Division) of the effect of inconsistent IDRS billings on taxpayers' accounts.

CORRECTIVE ACTION
After the IDRS programming is updated to correct FTP penalty calculations, we will notify the appropriate IRS offices of the effect of inconsistent IDRS billings on taxpayers' accounts.

IMPLEMENTATION DATE
Notification of inconsistent IDRS billings on Taxpayer's account - February 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 5
The Commissioner, SB/SE Division, should coordinate with the Chief Information Officer to determine the feasibility of correcting the Master File and IDRS computations of the 30-Day Rule for WTC disallowances for the current programming, or during the future IRS computer modernization process.

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CORRECTIVE ACTION
The Office of Penalties and Interest will coordinate with Customer Account Management (CAM) and Customer Account Data Engine (CADE) officials to include in the computer modernization work plans processing that will apply the 30-Day Rule to WTC disallowances when underpayment interest programming is developed.

IMPLEMENTATION DATE
Coordination with modernization projects - January 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 6
The Commissioner, SB/SE Division, should submit a request that the Chief Information Officer complete the Master File and IDRS computer programming for calculating the FTP penalty for taxpayers having WTC disallowances.

CORRECTIVE ACTION
The Office of Penalties and Interest will coordinate with BSD to complete the required program changes for the FTP penalty for taxpayers with a WTC disallowance using the existing August 2000 RIS or through a new RIS, if requested by BSD.

IMPLEMENTATION DATE
Submission of new RIS - January 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 7
The Commissioner, SB/SE Division, should correct the accounts for the estimated 72,500 taxpayers who were over assessed FTP penalties when WTCs were disallowed.

CORRECTIVE ACTION
In conjunction with BSD, the Office of Penalties and Interest will look into the feasibility of using a systemic change to correct these accounts. This will be done with a focus on open years in order to mitigate unforeseen consequences to other taxpayers. There is

a concern that any systemic change could affect many other taxpayers who were favorably impacted by the programming problem identified in this report. If a systemic change is not practical, a manual process will be used. The manual process will include stratification of the accounts and a cost analysis. Once our analysis is complete, we will take actions on the accounts as appropriate.

IMPLEMENTATION DATE
Completion of analysis – February 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of corrective action delays.

RECOMMENDATION 8
The Commissioner, SB/SE Division, should submit a request to the Chief Information Officer to correct the Master File and IDRS computer programming for calculating the 30-Day Rule and FTP penalty for taxpayers having Child Tax Credit (CTC), or Gas Tax Credit (GTC) disallowances.

CORRECTIVE ACTION
We will submit a RIS to include the disallowance of the CTC in the 30-Day Rule when Transaction Code 766 with Credit Reference Number 336 is input, and provide for the correct computation of the FTP penalty for CTC disallowances.

Because no systemic means exist to specifically identify a disallowance of a GTC credit, and the volume of such disallowances is low (only one such disallowance was found during the audit review), we will update the Internal Revenue Manual (IRM) to provide for the manual computation and restriction of interest when GTC disallowances are processed.

IMPLEMENTATION DATE
Request for Information Services submission date - January 15, 2004

RESPONSIBLE OFFICIAL(S)
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement of any corrective action delays.

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If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division at (202) 283-2200.